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IN THE

Supreme Court of the United States

October Term, 1971

No. 70-220

MORTIMER M. CAPLIN, Trustee in Reorganization of WEBB & KNAPP, INC., on behalf of debentureholders under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York, trustee, dated as of June 1, 1954,

Petitioner,

—against—

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENT

Opinions Below

The *en banc* opinion of the Court of Appeals (App. 84a-96a) is reported at 439 F. 2d 118. The opinions of the District Court (App. 58a-61a, 62a-66a, 67a-70a) are not reported.

Jurisdiction

The judgment of the Court of Appeals was entered on March 3, 1971 (App. 82a). The petition for a writ of certiorari was filed on May 29, 1971, and granted on December 7, 1971. The jurisdiction of the Court rests on 28 U.S.C. § 1254(1) and 11 U.S.C. §§ 47c and 521.

Question Presented

Does a trustee in reorganization under Chapter X of the Bankruptcy Act have standing to prosecute a private negligence cause of action in which the debtor has no interest, on behalf of an alleged class of debentureholders of which he is not a member, where any recovery admittedly would be paid to the debentureholders and not to the debtor and would not affect any plan of reorganization, and where the same claims are being prosecuted simultaneously in both federal and state courts of New York by debentureholders and a debentureholders' protective committee suing on their own behalf and representatively on behalf of all purchasers and all present and former holders of the debentures?

Statutes Involved

The pertinent provisions of Sections 47a and 70a of the Bankruptcy Act, 11 U.S.C. §§75a and 110a, and of Sections 167, 186, and 187 of Chapter X of that Act, 11 U.S.C. §§ 567, 586, and 587, as well as Section 312 of the Trust Indenture Act of 1939, 15 U.S.C. § 77*lll*, are set forth in an appendix to this brief, pp. A-1–A-5, *infra*.

Statement of the Case

By this appeal the trustee in reorganization of Webb & Knapp, Inc. seeks a judicial extension of the statutory powers granted him by the Bankruptcy Act in order to enable him to prosecute a private claim for damages on behalf of holders of unsecured debentures issued by Webb & Knapp. The claim in question is based on an alleged failure of Marine Midland Grace Trust Company of New York, as indenture trustee, to prevent Webb & Knapp from violating a particular negative covenant it undertook for the benefit of the debentureholders.

The petitioner attempts by this appeal to supersede as representative of the debentureholders the members of that group who have already asserted the same cause of action in a representative capacity in both federal and state courts in New York, and thus to preempt the class action field which heretofore has been carefully developed and regulated within the framework of Rule 23 of the Federal Rules of Civil Procedure and similar state remedies.

A. The Trust Indenture

On or about June 1, 1954 Webb & Knapp and Marine Midland, as indenture trustee, executed an indenture providing for the issuance by Webb & Knapp of 5% Sinking Fund Debentures due June 1, 1974 in the aggregate principal amount of $8,607,000, of which the principal amount of $4,298,200 remains outstanding (App. 44a-45a). The indenture was entered into and qualified in accordance with the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa, *et seq.* (App. 30a), and there is no claim that any provision required by the Act to be included in the indenture was not

included or that the indenture contains any provision prohibited by the Act.

The alleged breach of covenant by Webb & Knapp and the supposed failure of enforcement by Marine Midland concern Section 3.6 of the Indenture. Webb & Knapp there covenanted that so long as any of the debentures remained outstanding, it would not incur or assume indebtedness resulting from borrowings or from the purchase of real property or interests in real property on which it would be personally liable or to purchase any real estate, or interest in real estate, unless on the basis of computations (made as of the last day of the fourth month prior to such transaction) its "consolidated tangible assets" would equal 200% of certain liabilities. In determining "consolidated tangible assets" the Company was authorized, *inter alia*, to rely on and use appraisals made by its officers and approved by the Board of Directors "of real property, of interests in real property . . . or of the controlling stock interest in any corporation the principal assets of which consist of real property or interests in real property" (App. 45a; Indenture pp. 11-13).

The Company was required to file an officers' certificate of compliance annually with Marine Midland and did so (App. 45a-46a). In addition to such certificates, pursuant to the indenture Marine Midland requested and received separate officers' certificates stating specifically that Webb & Knapp was not in violation of Section 3.6 (App. 46a).

In accordance with Section 315 of the Trust Indenture Act of 1939, 15 U.S.C. § 77*ooo*, Section 10.1 of the indenture required Marine Midland to examine all certificates and reports furnished to it but authorized it, in the absence of bad

faith, to "conclusively rely as to the truth of the statements and the correctness of the opinions expressed therein, upon certificates or opinions conforming to the requirements of this indenture" and to "rely" and "be protected in acting or refraining from acting upon any resolution, certificate, opinion, notice, consent, request, order, appraisal, report, bond or other paper or document believed by it to be genuine and to have been signed and presented by the proper party or parties."

B. The Chapter X Trustee's Action

The pleadings do not put in issue the genuineness of the officers' certificates or appraisals furnished by Webb & Knapp or challenge their conformity to the requirements of the indenture. Nor is bad faith on the part of Marine Midland alleged.

The Chapter X trustee alleges, rather, that appraisals delivered to Marine Midland with the Section 3.6 certificates of compliance were "false and fraudulent and in fact at no time during the period 1958 through 1964 were the debtor's consolidated tangible assets equal to 200% of its liabilities as required by Section 3.6 of the indenture" (App. 46a-47a). He further contends that "Marine at all times knew, or in the exercise of reasonable diligence, should have known" that the officers' appraisals were "falsely and fraudulently inflated" and that "the ratio of the debtor's consolidated tangible assets to its liabilities was such that any borrowings or purchases by the debtor would and did constitute violations of the debtor's covenants as set forth in Section 3.6 of the indenture" (App. 47a).

The conclusory allegation is that Marine Midland's "failure to ascertain that the debtor was in violation of its obligations pursuant to the provisions of Section 3.6 of the in-

denture and its failure to take appropriate steps to protect the debentureholders [by preventing the debtor from borrowing any money or purchasing any property while the debentures were outstanding] either constituted wilful misconduct or gross negligence in violation of its obligations as Indenture Trustee" (App. 48a).

The reorganization trustee concludes that "by reason of the foregoing, the holders of the debtor's debentures under the indenture have suffered damages in the amount of $4,298,200" and demands judgment on their behalf (App. 48a).

There is no allegation in the trustee's complaint that Marine Midland at any time mishandled or even held any property belonging to Webb & Knapp or any property in which it had an interest, or received any money or other property in preference of its own interests over those of Webb & Knapp or its creditors or debentureholders, or otherwise engaged in any self-dealing. Nor is it alleged that Marine Midland released or surrendered or otherwise acted improperly with respect to any security underlying the obligations of Webb & Knapp to the debentureholders. The debentures are and always have been wholly unsecured.

Finally, no claim is made by the Chapter X trustee that Marine Midland's alleged failure to ascertain or prevent Webb & Knapp's breach of covenant caused or contributed to the insolvency or bankruptcy of Webb & Knapp, nor does the trustee purport to state a cause of action on behalf of the estate of Webb & Knapp. Plainly he recognizes that Marine Midland's substantive obligations under the indenture were to the debentureholders and for their protection alone, rather than for the benefit or protection of Webb & Knapp or its other investors or stockholders.

C. The Debentureholders' Pending Actions

Two separate actions based upon the same allegations as those stated by the Chapter X trustee have been instituted by and on behalf of the debentureholders of Webb & Knapp and are pending against Marine Midland. One is in the Supreme Court of the State of New York, New York County, and the other is in the United States District Court for the Southern District of New York.[1]

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[1] The state court action is entitled

"DAVID RAY, on behalf of himself and all other present and former holders of the 5% Sinking Fund Debentures of Webb & Knapp, Inc., due June 1, 1974,

Plaintiff,

—against—

MARINE MIDLAND GRACE TRUST COMPANY,

Defendant."

The action pending in the Southern District of New York is entitled

"HARRY LEWIS, Suing both individually and as Chairman of the Webb & Knapp, Inc. 5% Sinking Fund Debenture Protective Committee, an Unincorporated Association, on behalf of all purchasers of 5% Sinking Fund Debentures due 1974, issued by Webb & Knapp, Inc. similarly situated, and ABRAHAM A. TUROFF,

Plaintiffs,

—against—

MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK, HARRIS, KERR, FORSTER & CO., WILLIAM ZECKENDORF, B. A. TOMPKINS, ARTEMUS L. GATES, MAURICE ISERMAN, ARTHUR J. PHELAN, ARTHUR G. RYDSTROM, NICOLAS M. SALGO, ELLIOTT H. BINZEN, HERBERT I. SILVERSON, RUDOLF SMUTNY, JAMES A. VAN FLEET, ARNOLD M. GRANT, WILLIAM ZECKENDORF JR., EDWARD Y. BAUGEARD, JARED C. HORTON, ARTHUR T. ROTH, DAVID W. WALLACE, WILLIAM C. WARREN, JOSEPH P. BOHAN, HENRY R. BOSTON, O. HENRY BRIGGS, RONALD A. NICHOLSON, ROBERT B. ANDERSON, LEWIS W. DOUGLAS, THOMAS P. JERMAN, KENNETH A. KEITH, GRAYSON M. P. MURPHY, STUART F. SILLOWAY, HARRY V. LETT,

Defendants."

For the Court's convenience, copies of pertinent portions of the complaints in the *Ray* and *Lewis* actions are reprinted as part of the appendix to this brief.

Each of these actions is potentially broader in scope than the petitioner's representative suit.

First, each is brought on behalf of a broader group of plaintiffs than the group of present holders for whom the petitioner would sue. Ray sues for "all present *and former* holders" of the debentures, and Lewis sues for "*all purchasers*" thereof.

Second, the debentureholders' actions set forth additional allegations of fact and additional legal theories in support of their claims for damages. Thus, beside alleging negligent failure on the part of Marine Midland to prevent violation by Webb & Knapp of the assets/liabilities ratio prescribed by Section 3.6 of the indenture, *Ray* alleges culpable failure to accelerate maturity of the debentures upon the alleged happening of other defaults (A-9) and conflicts of interest (A-10). The *Lewis* complaint encompasses the material allegations of the complaints of both *Ray* and the Chapter X trustee (A-18 to A-19, A-13 to A-16) and further alleges violations by Marine Midland of Section 10(b) of the Securities Exchange Act of 1934 and of Rule 10b-5, which are not asserted by the Chapter X trustee. In addition, the *Lewis* plaintiffs have filed a motion for leave to amend their complaint to include claims based on alleged violations of the Trust Indenture Act, which also are not asserted by the Chapter X trustee.

Third, the *Lewis* action, which is grounded upon Rule 23, names many additional defendants in whose conduct Marine Midland is said to be implicated, including former officers and directors of Webb & Knapp and Webb & Knapp's accountants.

Notwithstanding the potentially broader scope of the *Lewis* and *Ray* cases, a decision permitting petitioner to

assert his claim necessarily would cut the heart out of those litigations or, if it did not, would subject Marine Midland to multiple and overlapping claims against it and expose it to double or triple recoveries on behalf of the same claimants.

The issue thus is cleanly framed: either the Chapter X trustee must preempt the debentureholders' class suits or his litigation role must be restricted to its traditional sphere of recovering property and asserting claims belonging to the debtor's estate. In the latter case, the alternative federal and state actions will go forward within the established framework of Rule 23 and parallel state procedures. The question is not simply one of the trustee's standing in the absence of any other claimants, but of whether the Bankruptcy Act or any other authority contemplates that if he should be moved to assert a representative claim for a group of creditors against a third party, his suit shall thereby sweep the field clean of other proceedings brought for the same group of claimants on the same causes of action under Rule 23 by members of these groups.

D. The Decision Below

The court below resolved the potential conflict between the petitioner and other litigants by adhering to the straightforward determination regarding a reorganization trustee's powers to sue which was first made by a court of appeals in *Clarke* v. *Chase National Bank*, 137 F. 2d 797 (2d Cir. 1943), and has been followed thereafter by every court to which the question has been presented. After rigorous analysis of the provisions of the Act, examination of the precedents, and review of the underlying object of the Act, the Court *en banc* determined by a vote of 5 to 2 that the litigating province of the Chapter X trustee under the Bankruptcy Act is to pursue claims belonging to the estate

of the debtor which he is appointed to administer and not to divert his attention and the debtor's resources to the pursuit of property or claims belonging to others in which the debtor has no interest.

The Court of Appeals noted that "whether it is possible and, if so, desirable to go further and permit the trustee to enforce individual claims of security holders against third parties" is a "policy decision to be made by the legislature, not by our overruling soundly reasoned decisions of our distinguished predecessors, who knew the statute every bit as well as we do and construed it to mean what it rather clearly says" (App. 94a-95a). The court added that "with no showing that the *Clarke* decision has caused any real difficulty over the past twenty-seven years, Congress might well decide that it was best to adhere in the policy of allowing holders of bonds of debtors in reorganization to pursue their own remedies against third parties" (App. 95a).

Since the present action admittedly is not based on any claim belonging to the debtor or related to property of the debtor, the court upheld the decision of the District Court dismissing the petitioner's plenary action and counterclaim.

Summary of Argument

The basic argument advanced by the petitioner and supported by the Securities and Exchange Commission is founded ultimately on out-of-context snippets from the legislative history of Chapter X referring to the need for an "independent trustee" in reorganization proceedings for the "protection of investors."

As shown more fully hereafter, the legislative history relied upon by petitioner is utterly unrelated to the issue presented on this appeal. House and Senate reports alike, the underlying SEC study, and the testimony cited by petitioner

are all directed to the need for establishment of an independent trustee "as the focal point for formulation and negotiation *of a plan of reorganization*"[2] and to provide "adequate representation" of security holders "*in the* [reorganization] *proceedings*"[3] (emphasis added). There is not the slightest suggestion anywhere in those sources that the reorganization trustee has been granted power to prosecute claims for damages against third parties for the private benefit of sub-groups of security holders or creditors of debtors in reorganization where no part of the recovery would benefit the estate. The legislation enacted by the Congress on the strength of the evidence presented to it granted no such powers, as the court below and its predecessors have consistently held over the years, nor can such powers sensibly be thought to be implicit in the statute's scheme or "in keeping with the underlying purpose of Chapter X" (SEC Br., p. 10). The Bankruptcy Act is extraordinarily explicit in defining the precise causes of action which may be asserted by a reorganization trustee (Sections 70(a)(5) and (6), 11 U.S.C. §110(a)(5), (6)) and does not encompass the kind of claim which the trustee seeks to assert in this case.

Moreover, the power contended for by the trustee is altogether inconsistent with the legal framework carefully developed over the years for the prosecution of class actions on behalf of security holders and others. Under the petitioner's theory, once a Chapter X trustee embarks upon his duties and acquires some familiarity with a debtor's affairs, he becomes the single appropriate party to sue on behalf of persons who may be or may have been "investors" in the

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[2] H. Rep. 1409, 75th Cong., 1st Sess. (1937), 44.

[3] Hearings Before the Committee on the Judiciary, House of Representatives, 75th Congress, 1st Session, on H.R. 6439 subsequently amended and reported as H.R. 8046, June 1-4, 8, 9, 1937, at 163.

debtor, if he thinks they may have been wronged in any fashion by a third party. Once he sues, class actions prosecuted by aggressive and experienced members of the stockholders' bar apparently would be precluded and the balanced mechanism of Rule 23 presumably ignored.

In the present situation, all of the lower courts which have dealt with the problem have found a boundary between a trustee and other suitors necessary, and all have maintained the same limitation: the trustee's standing to sue is and should be confined to the pursuit of claims belonging to the debtor's estate. This is the limit set by Congress, and it is one which properly divides the trustee's status as a litigant under the Bankruptcy Act from the status of representatives selected under the provisions of Rule 23 and state equivalents.

ARGUMENT

I. The Petitioner lacks standing to prosecute a damage suit for debentureholders against a third party in which the recovery, if any, would benefit the debentureholders alone and affect neither the estate of the debtor nor a plan of reorganization.

A. The Bankruptcy Act defines the Chapter X trustee's powers entirely in terms of his succession to the debtor's title to specified kinds of property.

The provisions of the Bankruptcy Act which define a Chapter X trustee's powers and duties leave no ambiguity as to their source and extent. In specific application, as in theory, they derive entirely from the trustee's succession to title to the debtor's estate. While the Congress undoubtedly contemplated that these broad powers would in fact protect the interests of a debtor's public investors, the Bankruptcy Act which it authored makes clear the precise ways in which this is to take place. Protection of investors

was a Congressional goal, but the Bankruptcy Act—specifying recoupment of the debtor's assets—is the blueprint for the trustee's role in its achievement.

The title, rights, powers and duties of a trustee in reorganization are described in the first instance by Sections 186 and 187 of the Bankruptcy Act and, so far as concerns a trustee's title to property or causes of action and his right to assert claims, they are more particularly specified in Sections 47(a) ("Duties of Trustees"), 60 ("Preferred Creditors"), 67 ("Liens and Fraudulent Transfers"), 70(a) ("Title to Property"), and 167(3) (concerning the reporting of causes of action "*available to the estate*"). Since there is no allegation here of preferential or fraudulent transfers or liens, Sections 60 and 67 are of no importance in this action.

Sections 186 and 187 provide as follows:

> "Sec. 186. A trustee, upon his appointment and qualification, shall be vested with such title as a trustee appointed under section 44 of this Act would have.
>
> "Sec. 187. Where not inconsistent with the provisions of this chapter, a trustee, upon his appointment and qualification, shall be vested with the same rights, be subject to the same duties, and exercise the same powers as a trustee appointed under section 44 of this Act, and, if authorized by the judge, shall have and may exercise such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the debtor."

The title acquired by a trustee appointed pursuant to Section 44 is set forth in painstaking detail in Section 70 of the Act. It provides in pertinent part as follows:

"Sec. 70. Title to Property. (a) The Trustee of the estate of a bankrupt and his successor or successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this Act . . . to all of the following kinds of property wherever located (1) documents relating to his property; (2) interests in patents, patent rights, copyrights, and trade-marks, and in applications therefor . . . (3) powers which he might have exercised for his own benefit, but not those which he might have exercised solely for some other person; (4) property transferred by him in fraud of his creditors; (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered . . . (6) rights of action arising upon contracts, or usury, or the unlawful taking or detention of or injury to his property; (7) contingent remainders, executory devises and limitations, rights of entry for condition broken, rights or possibilities of reverter, and like interests in real property, which were nonassignable prior to bankruptcy and which, within six months thereafter, become assignable interests or estates or give rise to powers in the bankrupt to acquire assignable interests or estates; and (8) property held by an assignee for the benefit of creditors appointed under an assignment which constituted an act of bankruptcy, which property shall, for the purposes of this Act, be deemed to be held by the assignee as the agent of the bankrupt and shall be subject to the summary jurisdiction of the court."

Nothing whatever in the foregoing provisions suggests that the trustee succeeds to rights of action which belong to

third parties. Specifically, the trustee is vested on appointment with the *title of the bankrupt* to specified kinds of property, none of which has the slightest relation to the right of action which the trustee claims to assert here.

Specific provisions of the Act such as Section 70(a)(5) and (6) are expressly addressed to the matter of title to rights of action, and they particularize the litigation rights to which the trustee succeeds; but they pointedly do not embrace specifically or by description the right of action asserted here. It therefore seems patent that the trustee was not intended to be granted any such title.

The duties of a trustee appointed pursuant to Section 44 are set forth in similar detail in Section 47(a). So far as concerns the Chapter X trustee's standing to assert the claim made in the plenary suit and by counterclaim in the reorganization proceedings, only the following passage appears to be pertinent:

> "Sec. 47. Duties of Trustees. (a) Trustees shall (1) collect and reduce to money the *property of the estates* for which they are trustees . . ." (Emphasis added.)

With specific reference to Chapter X, Section 167 provides:

> "Sec. 167. The trustee upon his appointment and qualification—
>
> * * *
>
> "(3) shall report to the judge any facts ascertained by him pertaining to . . . any causes of action *available to the estate* . . ." (Emphasis added.)

Again, nothing here imposes a duty or grants power to attempt to collect a claim which is not the property of the estate, but of third-party claimants against the estate.

The order appointing the petitioner as a Chapter X trustee granted no greater powers to him than those contemplated by the statute. So far as relevant here, Order No. 3, dated May 18, 1965, directed that

> "5. The Trustee shall be vested with the title to all the *property of the Debtor*, of whatever kind and wherever located; and shall be vested with all the rights, powers and duties of a trustee appointed under Chapter X, and, when not inconsistent therewith, of a trustee appointed under Section 44 of the Bankruptcy Act; and shall have and may exercise such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the *property of the Debtor*.
>
> • • •
>
> "7. Without limiting in any way the generality of the foregoing provisions of this order, the Trustee is specifically authorized:
>
> • • •
>
> "(h) To collect and receive all revenues, rents, issues, income, and profits, and all outstanding accounts, choses in action, and credits *due or becoming due to the Debtor*;
>
> • • •
>
> "(n) To institute, prosecute, defend, compromise, intervene in, or be substituted as a party in any suit, action, or proceeding, at law or in equity or in courts of bankruptcy, in State or Federal courts either within or outside of the Southern District of New York, or before any State or Federal administrative agency, as he may deem necessary or proper for the protection or *preservation of the Debtor's property*;
>
> • • •

> "(p) To do any and all said things, and to make such payments and disbursements out of the property and assets of the estate as may be needful or expedient for the preservation, protection, maintenance, or operation of *the Debtor's property, assets, and business.*" (Emphasis added.)

It is apparent that both the applicable statutory provisions and the order of May 18, 1965 are directed to the collection, protection and preservation of the debtor's property wherever located, including causes of action belonging to the debtor. Neither refers to the pursuit of claims of third parties which do not belong to and have never belonged to the debtor.

Neither the Bankruptcy Act nor Order No. 3 confers upon the Chapter X trustee either the title or the right, power, or duty to maintain the claim alleged in these pleadings on behalf of debentureholders, who in any event are demonstrably eager and able to protect themselves.

Against the express language of the Bankruptcy Act, the trustee erects and the belabors a vague, ill-defined theory of "investor protection" which features general quotations shifted subtly from their original reference to the preservation of a debtor's estate (in which investors of course have an interest) to the implication that the trustee alone is authorized "to investigate and enforce *all* claims of investors and creditors" (Pet. Br. 9; emphasis added). The petitioner cites in support of this theory (i) remarks of then-Commissioner Douglas of the Securities and Exchange Commission in support of the enactment of the bill which became the Chandler Act (Pet. Br. 9-10), and (ii) an excerpt from a House Report on that bill (Pet. Br. 10-11).

The material quoted is not remotely directed to the issues before this Court and, after all is said and done, the simple fact remains that the Act, as ultimately enacted by the Congress, particularizes in fine detail the powers of the trustee and the causes of action to which he acquires title, but does not grant the power to sue on claims belonging to third parties.

Taking the materials cited by the petitioner in support of the supposed "Congressional scheme" to set up an omnipotent trustee in the order in which they are advanced, it should be emphasized that (a) the legislative history of the Chandler Act nowhere refers to the idea of a trustee's suit outside his role as protector of the estate; (b) references to the Trust Indenture Act of 1939 are window dressing, because the respondent's duties pursuant to that Act are not in issue in this suit, in which petitioner's complaint attempts to assert no claim whatsoever under that Act; and (c) the triad of remedies adopted by Congress in 1938-39 to protect public investors listed in petitioner's brief (Pet. Br. 13) fails to include a significant fourth remedy of 1938, the class action device codified in Rule 23 of the Federal Rules of Civil Procedure in that year.

In the first place, a thorough reading of the legislative history cited by petitioner reveals it to be unpersuasive in supporting his position. Certainly, one of the objects accomplished by the Chandler Act was the creation of the independent trustee; but in concluding its discussion of his role, the House Report on the Chandler Act cited by petitioner summed up (on the very same page he cites) the reasons for its necessity:

> "Under the bill the independent trustee will serve as *the focal point for formulation and negotiation*

> *of a plan for reorganization.* This important function under the present system has been left to the inside few. That normally has meant leaving it to the management and the investment bankers. It should no longer be left in these hands since those persons too often have interests conflicting with those of investors."[4]

As a reading of the Report makes clear, the independent trustee's office was created so that a neutral, detached party would control the debtor's reorganization itself. The trustee was to tip the scales to a proper balance of power in bankruptcy proceedings between the debtor on one side and investors and creditors on the other.

This is far removed from any implication in the legislative history which would support the idea that Congress ever contemplated that the trustee might prosecute damage suits against third parties on behalf of a group of creditors when no part of the prospective recovery would benefit the debtor's estate. The indisputable fact that the Chandler Act was drafted with the point of view of the investor in mind means no more than that the independent trustee, rather than the debtor or the persons who had formerly acted on its behalf, is now the one who presides in formulating the plan of reorganization, proposes the reorganization plan to the court, and basically manages the reorganization proceeding as an arm of the court.[5] Petitioner points to nothing in the history of the Act which sanctions the trustee's

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[4] H. Rep. 1409, 75th Cong., 1st Sess. (1937), 44 (emphasis added); compare petitioner's brief at pp. 10-11.

[5] *See id.* at 42-44; Hearings Before the Committee on the Judiciary, House of Representatives, 75th Cong., 1st Sess., on H. R. 6439 subsequently amended and reported as H. R. 8046, June 1-4, 8, 9, 1937, p. 376.

proposed diversion from his duties as reorganizer to the additional role of volunteer prosecutor of creditors' personal claims which are not assets of the debtor.

Secondly, the petitioner's references to the Trust Indenture Act are even less apposite. *Other* litigants suing Marine Midland have contended in an action brought pursuant to Rule 23 that the respondent has violated this Act; but the petitioner himself makes no such allegation. Instead, the implied attempt to cast his theory of standing momentarily in the guise of a special right of a Chapter X trustee to sue an indenture trustee—a notion not even remotely supported by the Bankruptcy Act or the Trust Indenture Act—is camouflage masking the true nature of his grandiose claim to be the only proper enforcer of *all* claims of investors and creditors (Pet. Br. 9), however they may arise.

Finally, as is set forth more fully herein, the petitioner omits Rule 23 entirely from his catalogue of measures enacted by Congress for the protection of investors and invokes supposed dilemmas long since solved by that rule.

In summary, the Bankruptcy Act clearly enumerates the trustee's powers, which do not include the preemption of investors' own suits for their "protection" but instead are limited to the preservation of the debtor's estate and the formulation of a plan of reorganization for the benefit of all investors and creditors of a debtor.

B. The statutory limitation of the trustee's litigation authority to the recovery and preservation of the property of the debtor is neither "narrow" nor "hypertechnical."

In his brief, the petitioner seeks to portray the judgment of the Court of Appeals in this case as erroneous and atypical by describing the distinction drawn there between suits

which a Chapter X trustee may maintain and those which he may not as "narrow" and "hypertechnical" (Pet. Br. 22). He contends that an attempt to distinguish between actions based on pursuit of the debtor's assets and all other sorts of claims is excessively rigid and formal, and that it stands in the way of appropriate concepts of investor protection.

The contours of this argument reveal the flaw in the petitioner's position on this appeal. Were he seeking simply a clarification or even a moderate extension of a Chapter X trustee's litigation authority, he might appropriately urge a reformulation of the boundaries of his duties in principled terms in order to prevent lower courts' errors.

But this is not what the petitioner attempts at all. It is impossible to glean from his brief any definition whatever of what he considers to be the *proper* limits to be placed upon a trustee's powers to assert claims as the single appropriate representative of groups of which he is not a member and which do not claim that the rights in question arise in any way out of the debtor's property which he protects. In fact, he seems to envisage no limits.

The petitioner's argument does not attempt to portray the claims in issue as property of the debtor's estate in any sense, for this is impossible. Instead, it is a broadside attack upon the idea that protection of the debtor's property—stigmatized as a "hypertechnical" or "niggling" notion (Pet. Br. 17) in spite of its universal acceptance and application heretofore—should be a limit at all. The argument runs as follows: (a) the very idea of a "res" belonging to the estate is a narrow concept which serves no useful purpose; (b) the trustee has assembled extensive files of all sorts; (c) the debentureholders of Webb & Knapp are investors and are part of a group intended by Congress to

receive the benefits of a variety of protective statutes; and (d) therefore the trustee ought to be permitted to use information in his files on their behalf.

The problem inherent in this form of argument, in addition to its refutation in section after section of the Bankruptcy Act, is that it never addresses the questions of why the limits of the debtor's property are no longer appropriate under present conditions or what boundary notions are suggested to replace them.

Presumably the petitioner would not press his theory to the limits implicit in his present statement of it, i.e., that he is or should be deemed to be authorized by the Bankruptcy Act to serve as the exclusive enforcer of *all* claims of investors against third parties about which he has information. For example, if a large group of the debentureholders had been gulled into buying their Webb & Knapp debentures on the open market by glowing false statements about the company made knowingly or recklessly by a securities analyst unaffiliated with the company, would the trustee contend that his subsequent knowledge of the true state of Webb & Knapp's affairs made him the only appropriate claimant on their behalf? Could he maintain a securities fraud action as their representative against accountants or even lawyers against whom Webb & Knapp itself had no claim but who had played a role in the analyst's touting?

It is assumed that the petitioner's argument is not intended to extend this far. Likewise, he presumably would not argue that he is the statutory class representative of any members of the existing Webb & Knapp debentureholders' protective committee who assemble for a meeting in his presence and suffer some sort of tortious injury there at the hands of a third party. Surely he would admit that any personal claims of investors which he is allowed to preempt for

litigation purposes are confined to those having some appropriate nexus with the debtor's estate which the trustee protects.

But once this is admitted, it becomes difficult to define any nexus more appropriate than—or even separate from—the status of the claim as a part of the property of the estate. Any other formulation (of which the petitioner suggests none) would be reduced to an *ad hoc* rule of no rule at all, a case-by-case determination that given claims either are or are not sufficiently close to the core of the trustee's true responsibilities vis-a-vis the debtor's property to allow him to preempt them. No matter how it is stated, the petitioner cannot escape the fact that the vast bulk of any trustee's duties are confined to preservation of the debtor's assets, and any extension of his powers as a practical matter must be defined in terms of an expansion outward from this core.

A few of the cases cited by the petitioner do involve some extensions outward from the core. For example, in *McCandless* v. *Furlaud*, 296 U.S. 140 (1935), the Court held that an equity receiver could assert a claim to recover diverted assets of the debtor by suing in the name of its creditors, whereas the debtor itself would have been barred from suing by complicity in the fraud.[6] But in every such case, as in *McCandless*, the property in question was a part of the estate and the extensions were devised to enable a trustee or equity receiver to overcome some formal barrier to its preservation or recovery for the trust. *See, e.g.*, *Central Hanover Bank & Trust Co.* v. *President and Directors of Manhattan Co.*, 105 F.2d 130, 131-32 (2d Cir. 1939).

In the present case, however, the petitioner cannot even begin to bring himself within any such principle. Instead,

[6] This case is discussed more fully at p. 35, *infra*.

he presents a direct attack upon the very idea of any limiting concept governing his powers, based upon a claim which belongs entirely to the debentureholders and not to the estate. Consequently, the argument he maintains cannot be subjected to close scrutiny without revealing that it proposes a radical departure from previous thinking in this area of the law.

We have argued above that there is no basis for such a departure in the legislation which the petitioner invokes. In addition, this new role for the Chapter X trustee could not in any beneficial way affect his own basic duty, planning the debtor's reorganization; and still further, it is unsupported by any previous case dealing with the powers of either a trustee or an equity receiver.

C. Any recovery on behalf of the debentureholders will not affect the trustee's plan of reorganization for Webb & Knapp.

In his brief, the petitioner takes the position that the Court of Appeals was "simply wrong" in observing that any recovery by or on behalf of the debentureholders against Marine Midland would not affect the trustee's formulation of a plan of reorganization (Pet. Br. 23). Petitioner's argument, however, fails altogether to deal with the principal point made by the Court of Appeals in this regard (App. 92a) and is itself "simply wrong" in its analysis of that Court's reasoning with respect to subrogation (App. 91a-92a).

As to the main point, petitioner does not answer the Court of Appeals' adoption (App. 92a) of Judge A. N. Hand's observation in *Clarke, supra,* 137 F.2d at 800, that

> "Each creditor, including the debenture-holders, can prove the full amount of his claim, and only to the extent that a debenture-holder fails to satisfy it from the bankruptcy estate will he suffer a loss which he can assert against the defendant through its failure to enforce the negative covenants."

In short, the claim against Marine Midland could not be prosecuted to judgment until the results of the reorganization become known.

The point may be illustrated by an example. Suppose the debtor's estate was sufficient to pay off the debentureholders at 100 cents on the dollar. Obviously no claim could be asserted in such circumstances against Marine Midland, even if it had failed, as alleged, to enforce some covenant in the indenture; for there would be no damage. The principle involved is no different if the amount ultimately available for distribution is 75 cents, 50 cents, or, as in the present case, 4 cents on the dollar. Damages, if any, cannot be measured until the distribution ultimately is made. Only then can it be known what the debentures held are worth, and only then can it be known what the damages sustained have been, if any.

Talk of the "practical dynamics of bankruptcy reorganization," which petitioner says the Court of Appeals "failed to appreciate" (Pet. Br. 31), does not meet the point. It is hardly likely that adequately informed debentureholders would be agreeable to a plan of reorganization which deprived them of their fair share, with other unsecured creditors, of any distribution from the debtor's estate and gave in exchange only an undertaking by the trustee to pursue a cause of action on their behalf against third parties. Nor is it reasonable to think that a plan could be found to be "fair and feasible" and thus be confirmed if

it provided that the debentureholders' share of the distributive estate would consist solely of the services of the Chapter X trustee to pursue a naked chose in action on their behalf. Under existing class action procedures, the debentureholders could and should have it both ways, i.e., they have a right to a certain distribution which is their share of the bankruptcy estate plus a chance themselves to pursue an ordinary class action for the balance.

In any event, as the Court of Appeals found, if some device were fabricated by which debentureholders were deprived of their distributive share of the debtor's estate in favor of a claim against Marine Midland, the latter would in all likelihood have a right of subrogation and be entitled thereby to participate in the distribution, leaving the plan unaffected. Petitioner's argument to the contrary is this: subrogation might be denied to a party held liable to the debentureholders for the face value of their securities, so that the debentureholders would be satisfied in full and their claims against the Webb & Knapp estate would be withdrawn. As a result, additional funds would remain for distribution to the other creditors, and the plan of reorganization would be affected accordingly.

In fact, this argument is built upon sand because of the true nature of the debentureholders' claims against Marine Midland: although they have been stated in pleadings in terms of wrongdoing and "gross" negligence, these claims in fact are essentially charges that Marine Midland "*ought* to have known" of Webb & Knapp's alleged breach of its covenant regarding the assets/liabilities ratio to be maintained and ought to have rejected as false the officers' certificates of compliance delivered to it pursuant to the terms of the indenture and upon the terms of which it was entitled to "exclusively rely." Under the circumstances, any ulti-

mate finding of liability on the part of Marine Midland would be likely to require a radical reinterpretation of the responsibilities of all indenture trustees and, in any event, almost certainly could not involve the type of culpability which sometimes leads to a denial of subrogation rights.

But in any case, the subrogation and measure of damages issues are now not only hypothetical but virtually moot. A plan of reorganization has already been submitted for Webb & Knapp by the petitioner, involving a distribution of approximately four cents on the dollar to unsecured creditors, including the debentureholders. The plan has been approved by the Securities and Exchange Commission with only minor modification suggestions and is presently before the District Court.[7] Once the plan is consummated, any damage claim on behalf of the debentureholders will be fixed at the difference between the ultimate value of their securities (four cents on the dollar) and their principal value. Any further recovery on the debentureholders' behalf from third parties such as Marine Midland would be wholly apart from and subsequent to the reorganization plan, so that it literally could not affect that plan.

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[7] A copy of the Memorandum of the Securities and Exchange Commission on the Trustee's Proposed Plan of Reorganization, filed in the Reorganization Court January 27, 1972, has been lodged with the Clerk of this Court. That memorandum recommends an amendment to the plan to make absolutely clear that

> ". . . unlike the other claims and causes of action, any fund that may be recovered by the Trustee in the *Caplin* v. *Marine* litigation will inure solely to the benefit of the debenture holders.
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> * * *
>
> "A Chapter X plan is, among other things, a disclosure document. It should be a good one, and it ought to be at least as informative as a prospectus or proxy statement meeting the requirements of the securities laws. In our view, this Plan does not meet that standard. The obscurity of its discussion of the action against Marine Midland Bank could mislead some of the estate's general creditors." (pp. 14-15)

This development illustrates the tenuousness of the petitioner's statutory standing argument. The question of whether or not recovery by outsiders would affect the reorganization plan in any given case would depend in any event upon the fortuity of its timing. Presumably the presentation of a plan should not be made to wait upon the vagaries of the trustee's efforts to pursue claims on behalf of subgroups of creditors, as the petitioner's own decision to proceed with the Webb & Knapp plan shows.

No such conflict between the problems of delays which might occur in third-party litigation and the need for prompt development of a plan of reorganization could arise if the trustee were clearly understood to lack standing to pursue the debentureholders' personal claims.[8]

D. The courts have consistently held that a Chapter X trustee has no standing to prosecute claims of the kind asserted in this case.

Judge Friendly's opinion below includes an extensive analysis of the leading cases involving a Chapter X trustee's ability to assert claims on behalf of the debtor's debentureholders, in which he points out their unanimous consensus regarding the appropriate boundary for this power. As the Court of Appeals held, this authority has been limited previously in *every* Chapter X case to recovery of property of the debtor.

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[8] Although parallel issues have been posed by the trustee's objection to Marine Midland's proof of claim in the reorganization court, it is extremely unlikely that questions of this magnitude actually will ever be litigated in any "full presentation" in this context (Pet. Br. 20). Marine Midland's total claim, if pressed, would be worth only some $2,000 at the unsecured creditors' distribution rate of four cents on the dollar, as set forth in the Webb & Knapp Plan of Reorganization.

In addition, examination of the cases relied upon by the petitioner involving the powers of an equity receiver reveals that in this respect the limits upon the receiver's standing correspond precisely to the standing limitation upon trustees under the Bankruptcy Act.

1. *Chapter X trustee cases*

Petitioner bases his claims of precedent with regard to his status as statutory trustee upon an analysis of three previous cases which reached the federal appellate level.

The facts of the first of this trilogy, *Clarke* v. *Chase National Bank*, 137 F.2d 797 (2d Cir. 1943), are set forth in Judge Friendly's opinion below (App. 87a-89a). On motion to dismiss counts based on allegations remarkably similar to those now before the Court, the Second Circuit held that a Chapter X trustee did not have standing to assert claims on behalf of debentureholders against an indenture trustee where the latter failed to prevent the debtor from violating negative covenants of the indenture.

In *Clarke*, the Second Circuit clearly marked the divide between standing and no standing by distinguishing counts alleging failures to prevent breaches of covenants from counts alleging self-dealing by the indenture trustee or preferential transfers to itself.

Where a preference or self-dealing was alleged, the court upheld the Chapter X trustee's standing to sue because the recovery and application of such preference money would enlarge the estate of the debtor and thus affect the relative participations of the indenture trustee, the debentureholders, and all other claimants against that estate in the plan of reorganization (p. 801).

In contrast, the Court could not "see that the claims for breach of the covenants are any part of the property of the bankrupt or would affect the plan of reorganization. They at most would be a claim of the debentureholders not derived from the bankrupt's estate but arising through the alleged tortious action of the indenture trustee" (p. 800).

The case turned upon the distinction between causes of action alleging culpable failure by the defendant indenture trustee to prevent breaches of negative covenants barring, among other things, issuance of senior debentures, and causes of action alleging preferential payments to and self-dealing by the indenture trustee. The Second Circuit dismissed the former—analogous to the claims asserted here—as personal to the debentureholders and allowed the latter, which involved prospective recovery of property for the benefit of the debtor's estate.

Petitioner asked the Second Circuit to overrule its decision in *Clarke* and to adopt the dissenting opinion of Judge Learned Hand, who had found the claim of failure to enforce negative covenants prohibiting the corporate rearrangements in which the indenture trustee did *not* participate nevertheless to be property of the debtor's estate.[9] He reasoned that an indenture trustee's naked chose in action against a debtor for failure to enforce a negative covenant of the debtor expressed in an indenture is a "res," held in trust for the debentureholders. Also, property of the debtor delivered into the hands of an indenture trustee

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[9] The opinion of Judge Hand on which petitioner relies attempted to deal with the problem as one of defining the boundaries of the debtor's estate rather than simply abandoning this concept as would the petitioner. *Compare* Judge Hand's opinion in *Central Hanover Bank & Trust Co.* v. *President and Directors of Manhattan Co.*, 105 F.2d 130, 131-32 (2d Cir. 1939).

as security for payment of the debentures is a "res," held in trust for the debentureholders. Since the chose in action is thus a trust "res" and the debtor's property as security is also a trust "res," Judge Hand concluded that they are equivalent to one another and that, if either is wrongfully released by the indenture trustee, "it is a proper part of a reorganization to compel a[n] [indenture] trustee to restore the fund to that amount which it would have had had he not been derelict in his duties."

The reasoning, of course, is tautological—"res" equals "res." The conclusion drawn, however, does not follow. The two kinds of trust "res" identified by Judge Hand are equivalent only to the extent that debentureholders may have an interest in both the enforcement of the chose in action against the debtor and in retention of property delivered by the debtor as security for payment of outstanding debentures. Debentureholders may have causes of action against the indenture trustee for releasing either. The two types of trust "res" are *not* equivalent, however, from the point of view of the Chapter X trustee, whose proper interest and power is limited to recovery of the debtor's assets. Judge Hand's reasoning goes awash when he states that, whichever res is released, "the loss was nevertheless of the debtor's assets; the remedy will be in their restoration" (p. 802). This is not so. The "loss" which was the subject of the negative covenant counts in *Clarke* was not of "debtor's assets," but of a chose in action against the debtor, belonging to the debentureholders; their remedy was not restoration of "debtor's assets," but damages payable to them by the indenture trustee.

The majority in *Clarke* and the *en banc* majority of the Second Circuit in this case rejected Judge Hand's analysis

on the foregoing basis, by pointing to the totally different nature of the rights involved. The claimed loss of debentureholders' rights to have negative covenants enforced is not "equivalent to" property held in trust for the debtor, because it never constituted part of the debtor's assets and had a totally different origin in a contract between the debentureholders and their indenture trustee. Accordingly, it is not the province of the Chapter X trustee to pursue the matter.

To state this conclusion is not to beg any question, but simply to invoke and follow the terms of the Bankruptcy Act, which requires a trustee to collect the "property of the estate" (Section 47). It is no more conclusory than the statute.

Subsequently, Judge Learned Hand wrote the opinion for the majority on rehearing in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F.2d 555 (2d Cir.), *cert. denied*, 346 U.S. 835 (1953). In that case Judge Hand himself distinguished between two forms of guaranty obligations which allegedly were not enforced by the indenture trustee, allowing a Chapter X trustee to sue *only* for the one which arose out of a right which was clearly a part of the debtor's estate. The petitioner does not dispute this reading of the case directly, but instead denounces Judge Friendly's exposition of this distinction (App. 90a-91a) as "agonizing" and as a "sleight-of-hand." The petitioner then lapses into a digression, injecting once again the tacit assumption on which his appeal is based—the suggestion that no one else will "effectively" assert any claim with respect to which the petitioner trustee lacks standing if he does not (Pet. Br. 25).

Moreover, the petitioner overlooks one key point about the *Prudence-Bonds* situation. As shown in *Brooklyn Trust Co.* v. *Kelby, et al. In re Prudence Bonds Corporation*, 134 F.2d 105 (2d Cir. 1943), the "new company" whose standing to sue on behalf of bondholders was in issue in the *State Street Trust Co.* case in fact was no outside representative but actually nothing more than the bondholders collectively and exclusively. As stated by Judge Frank,

> "In 1938, the bankruptcy court entered an order approving separate plans for each of the "series" of bonds and a "general" plan for the debtor, the court having found that there was no "equity" for the debtor's general creditors or stockholders. Under the "general" plan, a new company was to be created; its stock was to be placed in a voting trust, all the voting trust certificates to be distributed pro rata among the bondholders; the debtor and trustees in bankruptcy were to transfer all their interests to this new company which was liable on all its bonds." *Id.*, at 108.

In short, the *State Street Trust Co.* suit, brought nominally by the "new company" as successor to the debtor and the trustee, was a suit solely by and for the bondholders and no one else. There was in effect no intervening representative suing on their behalf for they *were* the "new company," as the Second Circuit very well knew when it decided the matter of standing.

Finally, petitioner refers briefly to the Third Circuit Court of Appeals' holding in *In re Solar Mfg. Corp.*, 200 F.2d 327 (3d Cir. 1952), *cert denied*, 345 U.S. 940 (1953). In that case, too, a Chapter X trustee's standing was based on his allegations that the indenture trustees had received preferences, or had mishandled security or other funds to

be held by them for the bondholders, or were guilty of self-dealing to the detriment of the bondholders. The case is not "flatly inconsistent" with the decision below, as petitioner charges (Pet. Br. 26), but is instead perfectly consistent, as Judge Friendly's opinion points out (App. 91a, n. 4). The court of appeals for the Third Circuit explicitly determined in *Solar* that its decision was consistent with the earlier decision of the Second Circuit in *Clarke*.

2. *Equity receivership cases*

Pursuant to Section 187 of the Bankruptcy Act, the order appointing the petitioner as Chapter X trustee granted him powers, in addition to those contemplated by the statute, which a receiver in equity would have if appointed by the court.[10] *See generally* 6A Collier, *Bankruptcy* ¶ 8.08, at 34 (Rev. ed. 1971). Even in these circumstances, however, an equity receiver acquires

> . . . no greater or superior right or interest in the property coming into his hands than the debtor had and in which relation may be said to stand in the shoes of the debtor; and, furthermore, as a general rule the receiver takes the property in the same plight and condition, and subject to the same equities and liens, as he finds it in the hands of the person or corporation out of whose hands it is taken."

Black v. *Manhattan Trust Co.*, 213 F. 692, 693 (D. Ore. 1914). *See Moviers* v. *Lee*, 30 F. 298 (N.D.N.Y. 1887); *Roeblings Sons Co.* v. *Frederickson Logging & Timber Co.*, 153 Wash. 580, 280 P. 93 (Sup. Ct. Wash. 1929). The rule has been similarly stated in a leading receivership treatise:

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[10] This was also the case in *Clarke* v. *Chase National Bank*, 137 F. 2d 797 (2d Cir. 1943).

> "The ordinary equitable non-statutory receiver of an insolvent corporation makes his title (whatever title that is, either equitable or otherwise) through the corporation. He cannot through his appointment acquire that which the corporation never had. He represents the creditors of the corporation in the administration of his trust, his trust relates only to the corporate assets."

3 Clark, *Receivers* §362, at 619 (3rd ed. 1959).

The petitioner and the Securities and Exchange Commission both invoke exceptions to this rule, relying heavily in their briefs (Pet. Br. 14; Sec. Br. 23) on the Court's opinion in *McCandless* v. *Furlaud*, 296 U.S. 140 (1935), in support of the proposition that equity receivers have standing to sue third parties on behalf of bondholders without limitation. In *McCandless*, however, the receiver's claim involved *property of the debtor* which the debtor itself could not sue to recover because it would have been barred by the defense of consent or estoppel. Mr. Justice Cardozo took care to point this out in the concluding paragraph of his opinion, which completely rebuts not only the dissent in that case and the dissent below in this one, but also negates any reliance on this opinion by the petitioner and the Securities and Exchange Commission:

> "As we have striven to make clear, the receiver does not claim to have succeeded to the rights of the bondholders or noteholders to recover damages for deceit. The wrong that is here redressed is the unlawful depletion of the assets whereby the company was made insolvent and the creditors were defrauded of their lawful rights and remedies." 296 U.S., at 167. See Note, *Rights of Creditors of Insolvent Corporations—Greater Than Rights of Corporation*, 34 Mich. L. Rev. 1196 (1936).

Although the receiver sued formally in the name of creditors in order to invoke rights superior to the defense of estoppel against the corporate debtor, the rationale of the case is perfectly consistent with that of *Clarke* and the present action. Here the receiver is asserting creditors' claims which are wholly separate from the debtor's property and which, upon recovery, would not replace any assets which may have been unlawfully depleted.

The object of an equity receivership is to collect all assets of the debtor and distribute them among such creditors as have valid claims. *See, e.g.*, 2 Clark, *supra*, §578 at 943.

In this case, the trustee in his status as receiver is not bringing suit to collect an asset of the debtor, but instead is asserting a claim against a third party on behalf of the debtor's bondholders who themselves could bring suit. A receiver's power in equity has never been held to extend so far.[11]

E. The trustee is not the real party in interest.

In both its opinion in this case (App. 93a) and in the *Clarke* case, the Second Circuit held that the Chapter X trustee was also barred from asserting the debentureholders' claims by F. R. Civ. P. 17 (a), which is applicable in this case by virtue of General Order in Bankruptcy 37. Rule 17(a) requires that "Every action shall be prosecuted in the name of the real party in interest"; and since the

[11] This general rule is not contradicted by the cases collected in Note, *Power of Receiver for Corporation to Assert Causes of Action Vested Solely in Creditors*, 46 Yale L.J. 1229 (1937). The note suggests the possibility of a rule akin to the petitioner's position as a beneficial but "radical departure from" then-current equity practice—"beneficial" *because of defects in the class action mechanism of that day. Id.*, at 1234, n. 32; *see id.* at 1233-34. These defects have long since been remedied by the promulgation and subsequent amendment of F.R. Civ. P. 23.

trustee has been authorized by the Bankruptcy Act only to collect and reduce the property of the estate, he is not the real party in interest in any suit upon the debenture-holders' personal claims.

The "real party in interest," is the person "who, by the substantive law, has the right sought to be enforced." *Rock Drilling and Common Laborers' Local Union No. 17* v. *Mason & Hanger Co.*, 217 F.2d 687 (2d Cir. 1954), *cert. denied*, 349 U.S. 915 (1955). Except where a federal right is involved, the governing substantive law is the law of the state in which the federal district court sits. See 3A Moore, *Federal Practice* ¶ 17.07 at 224 (2d ed. 1970); 2 Barron & Holtzoff, *Federal Practice and Procedure* §482 at 7-8 (Wright ed. 1961).

As we have shown above, neither the provisions of the Bankruptcy Act, the terms of the order appointing the present Chapter X trustee, nor the pertinent decisions afford the slightest basis for any contention that the Chapter X trustee has standing (or proper interest) as a matter of right under federal law to assert the claim set forth in the pleadings before the Court. In *Clarke, supra*, the Court allowed the trustee to proceed with the causes of action for recovery of certain preferences as assets of the estate. However, regarding claims alleging failures to enforce negative covenants made solely for the benefit of the debentureholders, the Second Circuit said:

> "[T]he trustee in bankruptcy has no title to the claims embraced in the first and third counts and is not the real party in interest by whom such claims should be asserted under Rule 17(a) of the Rules of Civil Procedure, 28 U.S.C.A. following section 723c. Elkind v. Chase National Bank, 259 App. Div. 661, 20 N.Y.S. 2d 213, affirmed 284 N.Y. 726, 31 N.E. 2d 198." *Id.* at 801.

So also in the case at bar the Chapter X trustee has no claim to any right of action on behalf of the debentureholders against Marine Midland. The right to prosecute any cause of action on behalf of the debentureholders against Marine Midland is and always has been owned entirely by the debentureholders, and they are the only real parties in interest by whom such claims can be asserted under Rule 17(a).

The New York law appears to be the same. In *Barnes* v. *Hirsch*, 215 A. D. 10 (1st Dept. 1925), *aff'd mem.*, 242 N.Y. 555, *cert. denied*, 273 U.S. 709 (1926), where creditors of a bankrupt sought to assign certain tort claims to the trustee, the court held:

> "A trustee in bankruptcy has only such title and power as given by the Bankruptcy Act. He is a creature of that statute. No serious assertion is made here that these claims, indicated by the complaint, were property of the bankrupt. They were not assets which passed to the trustee because they belonged to the bankrupt." 215 A. D., at 13

Accord, Rock Drilling and Common Laborers' Local Union No. 17 v. *Mason & Hanger Co., supra:*

> "The causes of action which the trustee has by reason of the Bankruptcy Act, other than such as were property of the bankrupt, are causes of action to recover or follow assets."

It has been amply shown above that the alleged cause of action here cannot have been "property of the bankrupt" under any view, nor is it claimed that the action which the Chapter X trustee seeks to bring is "to recover or follow assets" which once belonged to the debtor.

II. The debentureholders are capable of asserting their personal rights against third parties without compulsory assistance from the trustee.

Both the petitioner and the Securities and Exchange Commission assert in their briefs that there is a supposed need for preemptive suits brought representatively by Chapter X trustees because of practical difficulties barring debentureholders from effectively asserting their own rights. Taking this argument to its logical conclusion, the petitioner candidly admits that if the sweeping preemptive role he asserts in relation to all claims of any kind which he may discover on behalf of any investors or creditors becomes law, it would have the effect of finally dispensing with even the possibility of other class actions in every instance in which a reorganization trustee intervenes (Pet. Br. 21). The petitioner argues that he is better qualified and therefore should be the *only* suitor in behalf of investor groups, even though Rule 23 would have to be substantially reshaped to permit this.

But the capacity of debentureholders themselves is not so moribund as the petitioner suggests. In fact, their actions have proceeded in the present case; and in all likelihood they would have advanced much further toward resolution of the issues than has the petitioner, had not his preemptive suit stood in their way. They have been delayed by the threat implied in this action: that the expansion sought for the trustee's power to that of self-appointed volunteer class representative in all cases would undermine the mechanism of Rule 23 which is currently so widely utilized by private representatives of investor groups, depriving them of control over their own causes of action.

A. The pending debentureholders' actions which the petitioner would preempt are among the means by which Congress intended the "investor protection" measures of 1938-39 to be carried out.

When the Congress enacted the Chandler Act in 1938, it created the powerful position of trustee, whose occupant was given broad authority to protect investors by gathering the debtor's assets and representing them in the formulation of a reorganization plan. But at the same time, as has been shown, the legislators restricted this designee's responsibility—as the duties of an equity receiver traditionally had been circumscribed in this respect, as well—to the specific tasks set out in the Act. Investors or creditors who possessed claims which were no part of the debtor's estate were permitted to retain control of their own litigations based upon them and were never thought to have ceded them to a trustee who is not a member of the class at all.

This pattern of divided responsibility for litigation between the trustee and private investors or creditors was strengthened with the enactment of the Trust Indenture Act of 1939. The legislative history of Section 312 of that act, 15 U.S.C. § 77*lll*, which concerns bondholder lists, establishes that this measure was intended to provide each bondholder with easier access to the lists of all those similarly situated so that an individual suitor might initiate concerted action on behalf of bondholders as a group. The Senate Report on the Trust Indenture Act expressly states that Section 312 was intended to overcome "obstacles to concerted action by bondholders," noting:

> "Section 312 of the bill meets the problem of *restoring to the bondholders control of their own destinies* by providing that the indenture shall include a requirement that the issuing company fur-

> nish to the trustee at stated intervals or at the request of the trustees, information in its possession or control as to the names and addresses of the bondholders. It also contains provisions under which the trustee must either give the bondholders access to such lists or, without disclosing the list itself mail out on the request and at the expense of any bondholder, communication supplied by him relating to the rights of the bondholder."[12]

Thus Congress contemplated that the bondholders, now armed with a valuable weapon for concerted action, would be able to enforce their own rights by way of litigation.[13] The reorganization trustee was not needed to represent the bondholders' personal claims.[14]

The enactment of this provision in the Trust Indenture Act followed closely and built upon the promulgation in the previous year of the Federal Rules of Civil Procedure and the broadened class action remedy of Rule 23.

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[12] S. Rep. 248, 76th Cong., 1st Sess. (1939), 6 (emphasis added). *See* Statement of Commissioner Eicher, Securities and Exchange Commission, Hearings Before a Subcommittee of the Committee on Banking and Currency, United States Senate, 76th Cong., 1st Sess. on S. 477, February 7, 1939, p. 30.

[13] Among the primary reasons for the passage of the Trust Indenture Act was the desire

> ". . . to provide machinery whereby . . . continuing disclosure may be made to the security holders, *and whereby they may get together for the protection of their own interests.*" (Emphasis added.)

2 Loss, *Securities Regulation* 725 (2d ed. 1961).

[14] The quotation contained in petitioner's brief (Pet. Br. 19) from Section 302(a)(1) of the Trust Indenture Act, 15 U.S.C. § 77bbb (a)(1), is taken from what is in effect the preamble of the Act, describing the *former* situation requiring regulation. Section 312 was enacted as a step toward facilitating action by bondholder groups and is inconsistent with any congressional intention to eliminate them in favor of a preemptive trustee.

Originally an invention of equity, the class action was extended by the adoption of the Federal Rules to the entire field of federal civil litigation. *See Hansberry* v. *Lee*, 311 U.S. 32, 41 (1940); *United Mine Workers of America* v. *Coronado Coal Co.*, 259 U.S. 344, 387-89 (1922); 3B Moore, *Federal Practice, supra*, ¶ 23.02[1]; 2 Barron & Holtzoff *Federal Practice and Procedure, supra* § 561. In recent years, it has been favored by many litigants asserting claims which are personal to investors or creditors. *E.g., Green* v. *Wolf Corp.*, 406 F.2d 291 (2d Cir.), *cert denied*, 395 U.S. 977 (1969); *Eisen* v. *Carlisle & Jacquelin*, 391 F.2d 555 (2d Cir. 1968); *Escott* v. *BarChris Construction Corp.*, 340 F.2d 731 (2d Cir.), *cert. denied*, 382 U.S. 816 (1965). As one court has put it,

> "The resolution in one litigation of the common questions relating to the existence, character, and materiality of the alleged [securities law violations] avoids the need for each injured investor to attempt to prove—and for the defendants to disprove—anew these basic allegations. Thus, it is virtually certain that a class action will 'achieve economies of time, effort, and expense, and promote uniformity of decision as to persons similarly situated.' Advisory Committee Notes to Rule 23, 39 F.R.D. at 102-103." *Dolgow* v. *Anderson*, 43 F.R.D. 472, 488 (E.D. N.Y. 1968), *rev'd on other grounds*, 438 F.2d 825 (2d Cir. 1971).

In the present case, one group of litigants suing in federal court in New York invokes Rule 23 to assert claims on behalf of individuals, a "Debenture Protective Committee," and a class composed of all purchasers, holders and sellers of Webb & Knapp debentures. *Lewis* v.

Marine Midland Grace Trust Company of New York, 68 Civ. 1764 (S.D.N.Y. 1968). The present amended and supplemental complaint in that action (A-12) recites the same factual allegations made by petitioner and charges that Marine Midland and others engaged in conduct violating the Securities Act of 1933, the Securities Exchange Act of 1934, and common law negligence principles.[15]

Discovery has been sought in the *Lewis* case but has been stayed by the district court as a direct result of the continuation of the present action.

It is therefore disingenuous for the petitioner to suggest that his pursuit of the common claims is "vigorous" and the debentureholders' efforts ineffective, since his own lengthy litigation over the question of his standing has been the major reason for delay in the private action he would summarily dismiss.

Another action, in a state court of New York, also has been brought on behalf of a class or classes of debentureholders. This suit is brought on behalf of the individual plaintiff and "all other present and former holders" of the debentures, and it presents all the claims made in the present case and more. The New York County Supreme Court has ruled that this suit may proceed as a class action, stating that *Elkind* v. *Chase National Bank*, 259 A.D. 661 (1st Dept. 1940), *aff'd* 284 N.Y. 726 (1941), which is cited by petitioner (Pet. Br. 19), is no longer the law in New

[15] In November of 1971, following the Second Circuit's decision herein and prompted, presumably, by footnote 5 in Judge Friendly's opinion (App. 92a), plaintiffs moved for permission to amend their complaint to include claims based on the Trust Indenture Act. That motion had been stayed pending the outcome of the petitioner's appeal to this Court.

York: *Ray* v. *Marine Midland Grace Trust Company*, N.Y.L.J., January 12, 1971, p. 19, col. 1 (Sup. Ct. N.Y. Co.). The decision is presently on appeal, and some discovery has been had.

The petitioner thus would at present preempt *two* ongoing suits by representatives of the debentureholders whom he characterizes as unlikely to be able to act "effectively" without his intervention. His plea for an expansion of his statutory powers thus is a direct attempt to seize control of the debenture holders' own law suits.[16]

B. Intervention by the trustee in the area of private litigation would hamper performance of his statutory duties and undermine the carefully developed scheme of investors' remedies under Rule 23 and otherwise.

The petitioner's claim in this case is closely analogous to that advanced by the petitioner in *State of Hawaii* v. *Standard Oil Co. of California*, No. 70-49, (March 1, 1972), 40 U.S.L.W. 4246, in which a State claimed to act in the role of *parens patriae* or, as the Court put it, "the general guardian of all infants, idiots and lunatics,"[17] in pursuing an antitrust action on behalf of its citizens.

In its *State of Hawaii* opinion, the Court pointed to the problems of possibly overlapping classes and double recovery inherent in any litigation by a State as representative of the economic interests of individual citizens; and the

---

[16] Petitioner's brief also expresses a patronizing attitude toward members of the securities bar located outside "the great financial centers," whom the petitioner assumes to be "unsophisticated" and not "aggressive" in serving private investors (Pet. Br. 19).

[17] *State of Hawaii* v. *Standard Oil Co. of California*, No. 70-49, (March 1, 1972), 40 U.S.L.W. 4246, 4248, quoting 3 W. Blackstone, *Conversations* 47-8 (E. Christian, ed. 1794).

Court insisted upon a clear expression of congressional purpose to authorize such a departure. The Court observed that "private citizens are not as powerless as the State suggests," and it pointed to the "definitely preferable" mechanism of Rule 23, with its specific rules for delineating workable boundaries in the area of class suits. *Id.*, at 4250-51.

The petitioner in the present action likewise would reach beyond his own authorized area of responsibility for the protection of trust property and bring a claim on behalf of private individuals—in this case in the face of legislation plainly expressing a contrary congressional purpose. He similarly would brush aside difficulties in defining the ultimate scope of his claim of authority to represent any and all investors and ignore problems of double recovery,[18] as well as the presence of Rule 23, by characterizing the debentureholders as akin to "infants, idiots and lunatics" in need of a general guardian. In addition, the petitioner asserts a claim to represent a class of individual debenture-

[18] Double recovery problems could be raised if the petitioner is authorized to pursue negligence claims on behalf of all present debentureholders, while members of this group themselves maintain class actions under the securities laws on behalf of all purchasers or sellers of the debentures during various years. In addition, the possibility of expanding any action on behalf of the debentureholders to name all defendants implicated in culpable conduct could place the petitioner trustee in a position of conflicting interest. The bulk of the defendants in the *Lewis* action are former officers and directors of Webb & Knapp, the persons who authored and submitted the valuation certificates which it is alleged that Marine Midland "ought to have known" were inaccurate. Yet the petitioner has already entered into settlements with certain key individual defendants on behalf of the estate, in the process adopting positions and making representations to the reorganization court which might raise serious problems of litigation tactics should he now attempt to sue the same persons on the basis of very closely related facts on behalf of the debentureholders. Were the actions kept separate as intended under all the applicable statutes and rules, no such difficulties would arise.

holders in pursuit of their personal claims in spite of a comparable unanimity of lower court opinions opposing such a notion.

As in the *State of Hawaii* action, the petitioner herein both mistakes the nature of the statute he invokes and belittles the availability of class actions under Rule 23, which the Court has said may "enhance the efficacy of private actions by permitting citizens to combine their limited resources to achieve a more powerful litigation." *Id.*, at 4250.

In summary, the trustee's present attempt to preempt any individual class action, if successful, would have the dual effect of both decreasing his effectiveness in his proper role as guardian of the debtor's property and at the same time undermining private litigants' incentive to bring a wide variety of such suits in the future. On the one hand, a trustee might be tempted to delay the consummation of a plan of reorganization to the detriment of some investors while pursuing the personal claims of others through years of litigation; and he might face conflicts between positions taken in litigation on behalf of the estate and related claims belonging to others. And on the other hand, if a Chapter X trustee's mandate extends to the preemption of *all* claims by investors or creditors of any company which later passes into reorganization, a cloud would hang over any class suit commenced under Rule 23 involving a corporation in financial distress. Unless such actions were already far advanced by the time of his appearance, the trustee might argue, in the words of petitioner herein, that he has superior access to the debtor's files and therefore is *the* appropriate class representative.

The petitioner's appeal is based ultimately on the implications he finds in legislative history of 35 years ago, which constituted timely commentary upon problems of that day. The situation has been altered drastically by a third of a century of practice under the new investor-oriented laws which were the products of that era and by the parallel explosion of private class action litigation. Petitioner's sketchy presentation suggests no evidence which would be likely to cause a legislative body to believe without further investigation of current practices that the former problems remain unaltered and require radical surgery upon Chapter X of the Bankruptcy Act. It affords even less justification for the proposed judicial reshaping of the long-established relationship between the Chapter X trustee's duties and the role of private litigants.

CONCLUSION

For the foregoing reasons, the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

JOHN W. DICKEY,
Attorney for Respondent,
48 Wall Street,
New York, New York 10005.

SULLIVAN & CROMWELL,
JAMES H. CARTER,
Of Counsel.

MARCH 1972.

APPENDIX

Statutes Involved

The Bankruptcy Act, 11 U.S.C. §§ 1, *et seq.*, provides in pertinent part:

Section 47 (11 U.S.C. § 75):

> Duties of Trustees. (a) Trustees shall (1) collect and reduce to money the property of the estates for which they are trustees . . .
>
> . . . .

Section 70 (11 U.S.C. § 110):

> Title to Property. (a) The trustee of the estate of a bankrupt and his successor or successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this Act . . . to all of the following kinds of property wherever located (1) documents relating to his property; (2) interests in patents, patent rights, copyrights, and trade-marks, and in applications therefor . . . (3) powers which he might have exercised for his own benefit, but not those which he might have exercised solely for some other person; (4) property transferred by him in fraud of his creditors; (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered . . . (6) rights of action arising upon contracts, or usury, or the unlawful taking or detention of or injury to his property; (7) contingent remainders, executory devises and limitations, rights of entry for condition broken, rights or possibilities of reverter, and like interests

in real property, which were nonassignable prior to bankruptcy and which, within six months thereafter, become assignable interests or estates or give rise to powers in the bankrupt to acquire assignable interests or estates; and (8) property held by an assignee for the benefit of creditors appointed under an assignment which constituted an act of bankruptcy, which property shall, for the purposes of this Act, be deemed to be held by the assignee as the agent of the bankrupt and shall be subject to the summary jurisdiction of the court.

* * *

Section 167 (11 U.S.C. § 567):

The trustee upon his appointment and qualification—

(1) shall, if the judge shall so direct, forthwith investigate the acts, conduct, property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, and any other matter relevant to the proceeding or to the formulation of a plan, and report thereon to the judge;

(2) may, if the judge shall so direct, examine the directors and officers of the debtor and any other witnesses concerning the foregoing matters or any of them;

(3) shall report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate;

* * *

(5) shall, at the earliest date practicable, prepare and submit a brief statement of his investigation of the property, liabilities, and financial condition of the debtor, the operation of its business and the desira-

bility of the continuance thereof, in such form and manner as the judge may direct, to the creditors, stockholders, indenture trustees, the Securities and Exchange Commission, and such other persons as the judge may designate; and

(6) shall give notice to the creditors and stockholders that they may submit to him suggestions for the formulation of a plan, or proposals in the form of plans, within a time therein named.

* * * *

Section 186 (11 U.S.C. § 586):

A trustee, upon his appointment and qualification, shall be vested with such title as a trustee appointed under section 44 of this Act would have.

Section 187 (11 U.S.C. § 587):

Where not inconsistent with the provisions of this chapter, a trustee, upon his appointment and qualification, shall be vested with the same rights, be subject to the same duties, and exercise the same powers as a trustee appointed under section 44 of this Act, and, if authorized by the judge, shall have and may exercise such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the debtor.

Section 312 of the Trust Indenture Act of 1939, 15 U.S.C. § 77*lll*, provides in pertinent part:

(a) The indenture to be qualified shall contain provisions requiring each obligor upon the indenture securities to furnish or cause to be furnished to the

institutional trustee thereunder at stated intervals of not more than six months, and at such other times as such trustee may request in writing, all information in the possession or control of such obligor, or of any of its paying agents, as to the names and addresses of the indenture security holders, and requiring such trustee to preserve, in as current a form as is reasonably practicable, all such information so furnished to it or received by it in the capacity of paying agent.

(b) The indenture to be qualified shall also contain provisions requiring that, within five business days after the receipt by the institutional trustee of a written application by any three or more indenture security holders stating that the applicants desire to communicate with other indenture security holders with respect to their rights under such indenture or under the indenture securities, and accompanied by a copy of the form of proxy or other communication which such applicants propose to transmit, and by reasonable proof that each such applicant has owned an indenture security for a period of at least six months preceding the date of such application, such institutional trustee shall, at its election, either—

(1) afford to such applicants access to all information so furnished to or received by such trustee; or

(2) inform such applicants as to the approximate number of indenture security holders according to the most recent information so furnished to or received by such trustee, and as to the approximate cost of mailing to such indenture security holders the form of proxy or other communication, if any, specified in such application.

If such trustee shall elect not to afford to such applicants access to such information, such trustee shall, upon the written request of such applicants, mail to all such indenture security holders copies of the form of proxy or other communication which is specified in such request, with reasonable promptness after a tender to such trustee of the material to be mailed and of payment, or provision for the payment, of the reasonable expenses of such mailing, unless within five days after such tender, such trustee shall mail to such applicants, and file with the Commission together with a copy of the material to be mailed, a written statement to the effect that, in the opinion of such trustee, such mailing would be contrary to the best interests of the indenture security holders or would be in violation of applicable law. Such written statement shall specify the basis of such opinion. After opportunity for hearing upon the objections specified in the written statement so filed, the Commission may, and if demanded by such trustee or by such applicants shall, enter an order either sustaining one or more of such objections or refusing to sustain any of them. If the Commission shall enter an order refusing to sustain any of such objections, or if, after the entry of an order sustaining one or more of such objections, the Commission shall find, after notice and opportunity for hearing, that all objections so sustained have been met, and shall enter an order so declaring, such trustee shall mail copies of such material to all such indenture security holders with reasonable promptness after the entry of such order and the renewal of such tender.

* * *

Complaint

SUPREME COURT OF THE STATE OF NEW YORK

COUNTY OF NEW YORK

DAVID RAY, on behalf of himself and all other present and former holders of the 5% Sinking Fund Debentures of Webb & Knapp Inc., due June 1, 1974,

Plaintiff,

—against—

MARINE MIDLAND GRACE TRUST COMPANY,

Defendant.

Plaintiff above named, for his complaint, respectfully alleges upon information and belief, except as to the allegations contained in paragraphs "1" and "23" which are alleged upon knowledge:

* * *

7. The 5% Debentures were not secured by any lien, but under the Indenture the said debentures were entitled to the benefit of certain restrictive covenants which, among others, included the following:

* * *

(b) Under Section 3.6 of the Indenture, W&K agreed that neither it nor its consolidated subsidiaries would incur or assume any indebtedness resulting from money borrowed or from the purchase of real property or interests in real property on which W&K or any of its said subsidiaries

were personally liable, nor would they purchase any real property or interests in real property, unless in either case, on a date not later than four months prior to the date of the transaction, but after giving effect to the transaction, consolidated tangible assets of W&K and its subsidiaries, as defined in the Indenture, equalled 200% of consolidated liabilities as therein defined.

(c) Under Section 3.11 of the Indenture, W&K agreed that within 120 days after the close of its fiscal year ending December 31, 1954, and within 120 days after the close of each fiscal year thereafter, W&K would file with the Indenture Trustee, an officers' certificate, stating that in the course of the performance of their duties as officers of the Company they would normally obtain knowledge of any default by W&K in the performance or fulfillment of any covenant, agreement or condition contained in the Indenture, and stating whether or not they have obtained knowledge of any such default, and, if so, specifying each such default of which they have knowledge and the nature thereof.

• • •

15. (a) Notwithstanding that compliance with Section 3.6 of the Indenture required that W&K maintain a two-to-one ratio with respect to its consolidated tangible assets and consolidated liabilities, as aforesaid, based on computations made not later than the four months period preceding a transaction involving the borrowing of money or the purchase of real property, Marine Midland, in the years subsequent to the issuance of the 5% Debentures through the year 1962, requested W&K to submit to it only once in

each year an appraisal of the assets of W&K for the purpose of determining whether W&K was in violation of the provisions of Section 3.6 of the Indenture.

(b) The said yearly appraisals delivered to Marine Midland, at least for the years 1961 through 1964, grossly overstated the assets of W&K and, as known to Marine Midland, said appraisals were based primarily on self-serving and unrealistic valuations which were not based on cost or market, but instead, upon the views of officers of W&K, who were not independent appraisers, as to what the properties could be sold for on a cash basis under favorable market conditions after their earning power shall have been clearly established.

(c) Marine Midland, as Indenture Trustee, knew, or should have known, that said appraisals were false and were not prepared in accordance with accepted standards of valuation of real estate and that at least during the period from 1961 until May 1965, W&K was not maintaining consolidated tangible assets equal to 200% of liabilities as required by Section 3.6 of the Indenture. During said period, the said ratio was substantially less than two-to-one.

(d) Marine Midland knew, or should have known, that by reason of W&K's inability to maintain the said two-to-one ratio at least during the period from 1961 until May 1965, the real estate borrowings and purchases of real estate by W&K and its consolidated subsidiaries constituted violations of Section 3.6 of the Indenture.

(e) Marine Midland wilfully and with gross negligence failed to prevent the said violations of Section 3.6 of the

Indenture and permitted W&K and its consolidated subsidiaries during said period to engage in a large number of transactions for the purchase of real estate or interests in real estate and to incur huge amounts of additional short-term indebtedness, which resulted in substantial losses and diminution of the assets of W&K and its eventual insolvency; all to the detriment, damage and injury of the 5% Debenture holders.

* * *

16. In further breach of its duties under the Indenture, Marine Midland knew, and was so informed by W&K, that events of default under the Indenture had occurred during the year 1963 in that the maturity of certain indebtedness of W&K in excess of $6,235,000 had been declared accelerated and due and payable by reason of the occurrence of events of default as defined in mortgages, indentures (other than the Indenture), or other instruments. As known to Marine Midland, W&K was unable to have said accelerations rescinded or annulled. Notwithstanding said knowledge, Marine Midland did not give written notice to W&K until on or about June 25, 1964, requiring W&K to effect the said rescission or annulment. Although the grace period under the Indenture (more particularly Section 6.1 thereof) expired on July 6, 1964, Marine Midland then failed to accelerate maturity of the principal of the 5% Debentures for almost one year thereafter, despite its knowledge that said default had not been cured, that W&K was unable to meet its debts as they matured, that W&K was in financial distress, and that W&K was causing its remaining unencumbered property to be pledged with other creditors; all

to the detriment, damage and injury of the 5% Debenture holders.

* * *

20. (a) At pertinent times herein, Marine Midland suffered from a conflict of interest between its banking business affairs and its position as Trustee under the Indenture, and by reason thereof it failed to take necessary steps to protect the interests of the 5% Debenture holders, as aforesaid.

* * *

22. By reason of all the foregoing, Marine Midland violated the duties owed by it as Indenture Trustee to the plaintiff and to every other member of the class herein, and it thereby caused damage, injury and loss to the present and former holders of 5% Debentures who constitute the class as aforesaid. Marine Midland is liable for the loss and damage suffered by each member of the class.

23. The members of the class are so numerous as to make it impracticable to join them all in this action. There are questions of law and fact common to the class. The plaintiff will fairly and adequately protect the interests of the class.

WHEREFORE, plaintiff demands judgment against the defendant, as follows:

(1) That the plaintiff and each other member of the class recover from the defendant herein damages for the wrongs herein complained of:

(2) That this Court grant to the plaintiff and the other members of the class such other and further relief as may be just and proper in the premises; and

(3) That this Court award to the plaintiff the costs and disbursements of this action, including reasonable fees to plaintiff's counsel and accounting and other experts.

NEMEROV & SHAPIRO
Attorneys for Plaintiff
Office and P. O. Address
52 Broadway
New York, N. Y. 10004
HA. 5-5660

Amended and Supplemental Complaint

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

68 Civ. 1764

HARRY LEWIS, Suing both individually and as Chairman of the Webb & Knapp, Inc. 5% Sinking Fund Debenture Protective Committee, an Unincorporated Association, on behalf of all purchasers of 5% Sinking Fund Debentures due 1974, issued by Webb & Knapp, Inc. similarly situated, and ABRAHAM A. TUROFF,

Plaintiffs,

—against—

MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK, HARRIS, KERR, FORSTER & CO., WILLIAM ZECKENDORF, B. A. TOMPKINS, ARTEMUS L. GATES, MAURICE ISERMAN, ARTHUR J. PHELAN, ARTHUR G. RYDSTROM, NICOLAS M. SALGO, ELLIOT H. BINZEN, HERBERT I. SILVERSON, RUDOLF SMUTNY, JAMES A. VAN FLEET, ARNOLD M. GRANT, WILLIAM ZECKENDORF, JR., EDWARD Y. BAUGEARD, JARED C. HORTON, ARTHUR T. ROTH, DAVID W. WALLACE, WILLIAM C. WARREN, JOSEPH P. BOHAN, HENRY R. BOSTON, O. HENRY BRIGGS, RONALD A. NICHOLSON, ROBERT B. ANDERSON, LEWIS W. DOUGLAS, THOMAS P. JEBMAN, KENNETH A. KEITH, GRAYSON M. P. MURPHY, STUART F. SILLOWAY, HARRY V. LETT,

Defendants.

PLAINTIFFS DEMAND A TRIAL BY JURY

Plaintiffs for their amended and supplemental complaint ("complaint"), by Wolf Popper Ross Wolf & Jones, their

attorneys, allege upon information and belief, except as to paragraphs "1(a)" through "1(c)" which are alleged on knowledge:

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COUNT ONE

1. (a) Plaintiff Harry Lewis purchased Webb & Knapp, Inc., ("the Company"), 5% Sinking Fund Debentures ("debentures") on November 15, 1963 and still retains them.

(b) Plaintiff Abraham A. Turoff purchased debentures in 1956 and sold them on October 19, 1966 at a loss.

(c) Plaintiff Webb and Knapp, Inc. 5% Sinking Fund Debenture Protective Committee ("Committee") was formed on June 7, 1967 to protect the interests of debenture holders. The members of the Committee are: Harry Lewis, Chairman; Louis Kipnis, Secretary; and Stephen Abrams. The Committee presently represents 152 debenture holders owning debentures with a face amount of approximately $275,000. These debenture holders purchased their debentures on various dates between 1954 and 1965.

2. Plaintiff Committee brings this Count on behalf of all debenture holders it represents.

3. All plaintiffs bring this Count upon their own behalf, those whom they represent and all other purchasers of debentures similarly situated.

4. Said purchasers of the debentures constitute a class so numerous as to make it impractical to bring them all before the Court. Plaintiffs will fairly ensure adequate

representation of the interests of the entire class of persons on whose behalf this Count is brought.

5. Questions of law and fact common to all members of said class are involved herein.

6. The Trust Indenture which is the subject of this action, and the bonds issued thereunder, were issued pursuant to a prospectus and registration statement filed with the Securities and Exchange Commission pursuant to the provisions of the Securities Exchange Act of 1933 (''Securities Act'') and the Trust Indenture Act of 1939 (''Trust Act''). Under the definitions described in Section 1.2 of the Indenture, the terms used therein have the meaning assigned to them in the Trust Act and Securities Act. The Trust Indenture is governed by all the Rules and Regulations of the Securities and Exchange Commission dealing with securities and trust indentures.

7. The acts complained of herein constitute violations of Section 10(b) of the Securities Exchange Act of 1934, as amended (15 U.S.C. § 78p(b), (''Exchange Act''), Rule 10b-5 promulgated thereunder (17 CFR 240.10b-5) and the common law. This Court has jurisdiction pursuant to Section 27 of the Exchange Act, (15 U.S.C. 78aa) and the doctrine of pendent jurisdiction.

* * *

9. From 1954 through 1964, the defendants employed devices, schemes and artifices to defraud, and engaged and continued during such period to engage in acts, practices and a course of conduct which was intended to and did operate as a fraud upon plaintiff and all other purchasers similarly situated, through the use of the mails and other means

and instrumentalities of interstate commerce in connection with the purchase and sale of the securities and bonds of the Company covered by the Trust Indenture herein.

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17. Under the terms of Section 3.6(a) of the Trust Indenture, the Company was barred from incurring or assuming any indebtedness resulting from money borrowed or from the purchase of real property or interest in real property unless its consolidated tangible assets were equal to 200% of the liabilities of the Company, as such provisions are specified in said Section.

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20. Pursuant to a plan or scheme and continuous course of conduct of the directors-officers of the Company, and with the knowledge and approval of Marine Midland and Harris, Kerr, the Company filed with the Indenture Trustee Marine Midland, false, fraudulent, reckless and exaggerated statements of the values of the real estate and other assets; such valuations which the directors-officers made or approved during the times when they served as such directors-officers were grossly, fraudulently and recklessly inflated by the directors-officers in order to meet the requirements of the Indenture regarding the restrictions on real estate and other transactions as required by Section 3.6 of the Indenture.

21. The directors-officers by their actions in making false, grossly exaggerated and reckless statements, and Marine Midland and Harris, Kerr by approving these actions, dis-

regarded the fiduciary duties which they owed to the debenture purchasers as well as violating their duties and obligations under the Securities Act, Section 10b of the Exchange Act and its implementing Rule 10b-5.

* * *

23. Marine Midland aided and abetted the fraudulent scheme of the directors-officers set forth in paragraph "20" above by:

(a) Accepting asset valuations given to it by the Company between the years 1955 and 1965 without independent investigation and verification of the valuations, and was grossly negligent and reckless in failing to ascertain the pertinent facts;

(b) these valuations were grossly inflated by the directors-officers in order to meet the requirements of the Indenture regarding the restrictions on real estate transactions unless the Company's assets were twice the liabilities.

(c) Marine Midland knew or, in the exercise of prudent care, should have known that the valuations were false and grossly inflated by the directors-officers.

24. Marine Midland was grossly negligent and reckless in performing its duties and responsibilities as Trustee and aided and abetted the fraud of the directors-officers in failing to disclose and concealing from plaintiffs and all other purchasers of the debentures that the Company was in default under the terms of the Indenture because the valuations were grossly inflated as a result of which the Company failed to comply with the requirements of the Inden-

ture and in not calling the entire issue in default by reason of this.

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26. Plaintiffs and all other purchasers of the indentures relied upon the fraudulent activities of the directors-officers and the actions of Marine Midland and Harris, Kerr in aiding and abetting this fraud when they purchased their debentures. At the time of the purchases, plaintiffs and all other purchasers similarly situated relied upon the fact that the Company was complying in all respects with the Indenture and was not in default, when in truth and in fact this was not so, since the fraud of the defendants concealed the true facts, that the Company was not in compliance. Furthermore, the fraud as herein alleged had the effect of artificially inflating the market price of the debentures.

27. Had plaintiffs and all other members of the class known the true state of affairs of the Company, its failure to comply with the Indenture and its defaults at the time they purchased their debentures they would not have made the purchases.

28. By reason of the foregoing, plaintiffs and all other purchasers of the debentures similarly situated have been substantially damaged, the exact amount of which is ascertainable only upon a full and complete accounting herein.

29. By reason of the acts and conduct complained of, plaintiffs and all other members of the class are also entitled to exemplary and punitive damages.

COUNT TWO

Against Marine Midland Grace Trust Company of New York

30. This count is brought on behalf of all persons who were the owners of the Company's debentures on any date during the period July 1, 1964 to July 31, 1964.

31. Plaintiffs repeat and reallege paragraphs "1", "2", "5", "6", "8", "11", "12" and "16" of this complaint.

32. Jurisdiction is based on the doctrine of pendent jurisdiction.

33. Said debentureholders constitute a class so numerous as to make it impractical to bring them all before the Court. Plaintiffs will fairly ensure adequate representation of the interests of the entire class.

34. On or about June 1, 1964 the Company defaulted on a $431,000 sinking fund payment and a $120,000 interest payment on said debentures. The Indenture provides for a thirty-day grace period as to interest payments. The Company made the interest payment on June 30, 1964 at 8:00 P.M., four hours before the end of the grace period.

35. Marine Midland, in violation of its duties as Trustee, and in complete disregard of the poor financial condition of the Company, which was not meeting its obligations, extended the Company's time to make the sinking fund payment to July 31, 1964, rather than calling the entire issue immediately due upon the effective date of the default. The

sinking fund payment was made on July 31, 1964, the last day of the extension.

36. Marine Midland was grossly negligent and reckless in not calling the entire issue due at the time of the default in light of the financial condition of the Company on that date, which Marine Midland knew, or in the exercise of prudent care, should have known.

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38. Plaintiffs and all other bondholders similarly situated were substantially damaged by the grossly negligent and reckless conduct of Marine Midland.

39. Plaintiffs repeat and reallege paragraph "29".

WHEREFORE, the plaintiffs demand judgment:

ON COUNT ONE

That defendants pay to plaintiffs and all other members of the class the damages which they have sustained from defendants' wrongs together with interest and punitive damages;

ON COUNT TWO

That defendant Marine Midland pay to plaintiffs and all other members of the class the damages which they have sustained from its wrongs together with interest and punitive damages;

ON BOTH COUNTS

Awarding plaintiffs the costs and disbursements of this action including reasonable counsel and accounting fees and such other and further relief as the Court may deem proper.

Dated: New York, N. Y.
December , 1969

WOLF POPPER ROSS WOLF & JONES

By: .....
A Member of the Firm
Attorneys for Plaintiffs
845 Third Avenue
New York, New York 10022
PL. 9-4600

In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-220

MORTIMER M. CAPLIN, TRUSTEE IN REORGANIZATION OF WEBB & KNAPP, INC., ETC., PETITIONER

v.

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

1. Respondent Marine Midland incorrectly states that "no claim is made by the Chapter X trustee that Marine Midland's alleged failure to ascertain or prevent Webb & Knapp's breach of covenant caused or contributed to the insolvency or bankruptcy of Webb & Knapp * * *" (Br. 6). The Chapter X trustee charged in identical language both in his complaint in the plenary action and in his counterclaim to Marine Midland's proof of claim in the reorganization proceeding (App. 47a-48a; 52a-53a):

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> The failure of Marine to take appropriate steps to prevent the borrowing of funds or the purchases of property by the Debtor enabled the Debtor to enter into countless transactions in violation of the covenant contained in Section 3.6 of the Indenture with resultant loss and diminution of assets of the Debtor which caused the net worth of the Debtor to be reduced from $25,066,657 as of December 31, 1958 to a deficit of $38,500,000 at the time of the filing of the petition in these proceedings.

Had Marine, in accordance with the indenture under which it accepted fiduciary obligations, prevented further borrowings and purchases of property by the debtor as soon as the debtor's liabilities exceeded half the value of its assets, the debtor presumably would not have fallen into its present financial difficulties. This situation thus is fundamentally the same as that in *McCandless* v. *Furlaud,* 296 U.S. 140, 158, where this Court pointed out that the effect of the defendants' conduct "was to saddle the company with liens beyond the value of its assets mortgaged and unmortgaged." Just as a receiver was there permitted to bring an action for recovery of the damages suffered by the bondholders and noteholders of the debtor company, the Chapter X trustee here should be permitted to seek recovery for the damages suffered by the debenture holders of Webb & Knapp.

2. Marine's brief concedes that a moderate extension of a Chapter X trustee's litigation authority might be appropriate, but argues that it "is impossible to glean" from petitioner's brief any definition of what petitioner considers to be "the *proper* limits to be placed upon a trustee's powers to assert claims"

on behalf of a group of investors, stating that petitioner "seems to envisage no limits" (Br. 21, emphasis in original). The "limits" in the present case are determined both in terms of the persons the trustee seeks standing to represent and the amount he claims for them. That is, he would represent in the lawsuit only the present holders of the debtor's debentures—persons who are, in any event, necessarily before the bankruptcy court as creditors of the debtor and whose claims are subject to adjustments in the reorganization plan. The amount sought in the lawsuit could not exceed the principal outstanding balance due on the debentures (with interest on that amount and costs).[1] These limits may be contrasted with (1) the judgment demanded in the complaint in the state court action (see appendix to Marine Br., pp. A–6 to A–11), where damages for all present and former holders of the debentures are sought, together with any other appropriate relief, and (2) the demand for judgment in the federal court suit (see appendix to Marine Br., pp. A–12 to A–20), which would recover actual and punitive damages for, among others, persons who purchased debentures and subsequently sold them at a loss.

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[1] See the dissenting opinion of Judge Learned Hand in *Clarke* v. *Chase National Bank*, 137 F. 2d 797, 802 (C.A. 2):

"What difference can it make that the beneficiaries of the covenants here in question were only a part of those—the creditors at large—who were aggrieved by the debtor's conduct? The others had not provided themselves with a guardian over their interests, and have no one whom they can call to account. Although the measure of the guardian's liability is that of his wards' losses, what bearing has it that there were others who have no claim to restoration? * * *"